I. Introduction: clear objectives but unclear indicators

While plausible explanations can be suggested for many of the economic and financial developments in 1996, they were nevertheless surprising in a number of respects. Equity markets in many countries rose sharply, often in the face of stagnant levels of economic activity and continuing low levels of inflation. European bond yield differentials narrowed as US bond rates increased, in marked contrast to patterns observed in 1994 and 1995. The dollar rose in tandem with the continued strength of the US economy, in spite of persistent and growing trade deficits. In Japan and the major continental European countries, investment spending failed to strengthen as normal in the wake of rising exports. In some parts of Latin America and Africa, prospects for sustained growth took a turn for the better, while in parts of Asia imbalances became more evident. And private capital flows to emerging markets exceeded previous records by wide margins, with international bond issues playing a prominent role. Were these surprising developments the product of fundamental economic forces or, rather, will they be reversed by such forces in the future?

One part of an honest answer is that we simply do not know. Rapid technological change and deregulation, which today profoundly affect all aspects of the global economy, increasingly cloud our sense of what is possible and reasonable. On the one hand, they hold out the positive prospect of faster productivity growth, improving living standards and rising profits. On the other, they may bring transitional difficulties and unexpected side-effects stemming from the interaction of many shifting forces: real, financial and even social. Cycles of excessive optimism and pessimism are a feature of human nature that may also have played a role in 1996. Moreover, the ability to explain and predict must also be constrained by the limits of our knowledge. There are many economic processes that we do not fully understand, particularly in the financial area.

Yet there is one thing that we do know with certainty. Inflation, excessive monetary expansion and fiscal laxity contribute to misconceptions and bad judgement in a variety of forms. These obviously include the resource misallocations likely in a world where both the standard of value and relative prices are fluctuating excessively. However, it is only as inflation recedes that other, more deep-seated damage done to the economy becomes more clearly evident. Indeed, some of the developments referred to above undoubtedly have their origins in the excesses of much earlier periods, the associated accumulation of debt stocks and the ongoing process of re-establishing macroeconomic balance. Governments, banks and financial markets each continue to be affected in important ways.

In the industrial countries, the very role of the state is now having to be reassessed in the light of a sound money standard and revealed limits to government borrowing. The governments of many countries, struggling with debts incurred at a time when all seemed manageable, had to cut their fiscal deficits further in 1996 despite generally slack economic conditions and low inflation. In this historical context, the exigencies of the Maastricht criteria must be judged to have played only a secondary role, though clearly an important one in terms of timing. More fundamentally, many governments in industrial countries began to question seriously whether they could still maintain all the regulations and honour all the promises made earlier to protect workers, pensioners and other beneficiaries of the social safety net. And the resulting uncertainties on the part of both consumers and investors are stretching out this process of fiscal consolidation by holding back spending, reducing tax revenues and thus further increasing the need for fiscal restraint to meet deficit targets.

What also became more evident in 1996 is that some banking systems have still not completely recovered from earlier periods of excessive credit growth. Most prominently, a full seven years after the bursting of the asset price bubble in Japan, several financial institutions went into receivership, the number and scale of company failures rose to record levels, and banking shares led a further decline in stock prices. While the Japanese economy showed some encouraging signs of recovery in 1996, concerns remain that "headwinds" arising in the financial sector, together with necessary fiscal restraint, will continue to dampen growth for some time. Considerations of a similar nature also led to increasing concerns about recent developments in a number of emerging markets, where the rate of credit expansion for the purchase of both securities and property has been very high in recent years, often against a backdrop of inflationary pressures and widening trade deficits.

Financial markets may also bear the lingering imprint of a period of high inflation. One possibility is that it gives rise to "money illusion", so that high nominal rates of return on investment become confused with real ones. Thus, when nominal rates decline in response to lower inflation, as in 1995 and 1996, a misconception arises that "real" rates have fallen as well. A second and complementary possibility is that market participants become habituated to the high real rates of return associated with the early stages of disinflation. In contrast, the rates which can emerge as central banks try to revive stagnant economies can seem unacceptably low.

Whatever the reason, the upshot in 1996 seems to have been a determined effort on the part of market participants to reconstitute yields by taking on higher levels of both credit risk and market risk. As noted above, there were record inflows of capital into emerging markets, generally at declining risk spreads. Bond yield differentials between higher and lower-quality sovereign debt dropped dramatically in both Europe and North America, in spite of there being only a very short history of fiscal probity. And finally, in international securities markets, investors accepted narrower margins, made loans to previously unknown borrowers, extended duration and experimented with new currencies and ever more complex instruments.

Two principal lessons can be learned from all of this. The first is already generally accepted: establishing price stability and a sustainable fiscal position must be given high priority. Unsound macroeconomic policies not only inflict damage at the time, but have long-lasting effects as well. The second lesson is that the health of the economy and that of the financial system are intimately intertwined. Macroeconomic instability, such as excessive credit creation and inflation, can lead to weakness in the financial system. Conversely, weakness in the financial system, whatever its origin, can also have macroeconomic implications.

This last point has always been well understood by monetary and supervisory authorities. Indeed, Chapter VIII of this Annual Report considers the efforts made by the official community over the last 25 years to identify policy anchors and institutional arrangements that will ensure both price and financial stability. The fact that the Basle Committee on Banking Supervision, the Euro-currency Standing Committee and the Committee on Payment and Settlement Systems were founded by and continue to report to the Group of Ten central bank Governors also attests to the belief that financial sector fragility has important implications for the conduct of monetary policy. It is nonetheless true that, in the light of more measured reflection on the Mexican crisis, the links between price and financial sector stability came to be more widely appreciated in 1996, as did the interdependencies between the industrial countries and the emerging economies. This recognition constitutes a major step forward in the conduct of public policies. Yet, as is noted in the Conclusion of the Report, many more steps will be required before all the outstanding problems arising from these interdependencies have been adequately addressed.

Economic developments and conflicting policy signals

The average level of inflation fell further in the industrial countries in 1996. This was to be expected in countries where significant output gaps continue to exist, but inflationary pressures were also less evident than might have been expected in the United States and other countries where capacity limits were being tested. In this environment, and confronted as well with uncertainty as to how best to respond to fiscal restraint, an upsurge in the price of financial assets and sometimes large exchange rate movements, monetary policy in the major industrial countries was not much changed during the year.

In the United States, the need to balance conflicting indicators was particularly acute. Furthermore, the interpretation problem was exacerbated by a pronounced inventory cycle and a quarterly pattern of growth that made it difficult to discern underlying trends. The fact that the unemployment rate was very low, and tending more to fall than to rise, argued for higher policy rates to counter incipient price pressures. On the other hand, the fact that similar arguments had been heard for at least two years, without any obvious signs of accelerating inflation, raised the issue of whether there had not been some fundamental change in the inflation process.

Various financial market developments also had conflicting implications for monetary policy in the United States. The continued rise in the value of the dollar, which had a disinflationary effect, weakened the case for higher rates, even if the associated deterioration in the trade account implied that this support could not be relied upon forever. In contrast, the continued rise in the US stock market, which in principle could be expected to spur both consumption and investment, led to calls for tighter policy, whereas the upturn in bond rates in early 1996 was interpreted by some as meaning that the work of the Federal Reserve had already been done for it. In the event, it was only after evidence of stronger economic growth and increased labour cost pressures emerged around the turn of the year that the Federal Reserve decided to raise the federal funds rate in March 1997.

Similar problems of interpretation and balance were observed in the United Kingdom. Growth quickened, unemployment fell, credit expanded and asset prices rose; yet inflation remained relatively stable. A related complication for policy formulation was the sharp appreciation in the value of sterling against the Deutsche mark, and even against the dollar. While its immediate disinflationary implications were welcomed, the UK authorities discounted its importance as an indicator for monetary policy, noting that the higher value of sterling might be only temporary and that it provided no relief from accelerating inflationary pressures in the domestic (non-traded) sector. In contrast, the strengthening of the Canadian dollar during most of 1996 was interpreted by the Bank of Canada, albeit against the background of considerably more economic slack than in the case of the United Kingdom, as a potential tightening of monetary conditions which warranted a policy response.

On the European continent the policy puzzles in 1996 had a structural as well as a macroeconomic component. Only in some of the smaller European economies were inflationary pressures evident. More generally in continental Europe, weak demand in 1996 was exacerbated by the need for fiscal restraint and uncertainties related to anticipated policy changes and the prospects for economic and monetary union. While export orders were relatively buoyant, investment spending failed to respond as normal. At the same time, European economies were also being subjected to significant supply-side shocks. The process of industrial restructuring in response to globalisation and technological change gathered pace and, in a context of inflexible labour markets, this contributed to a rise in unemployment in France and Germany to the highest levels of the postwar period.

Given all these influences, and with policy rates already at low levels, monetary policy in Germany was eased only slightly in mid-1996. The judgement made was that the problems being faced were fundamentally structural rather than demand-driven, and that a slight reduction in short rates could do little to alleviate them. Nevertheless, demand growth in continental Europe did receive some encouragement from the stronger dollar, rising equity prices, lower long-term interest rates in core countries and even larger declines in both short and long-term interest rates in other countries.

In Asia, the substantial strengthening of the dollar was an important aspect of the policy conflicts confronting that region. The effect of the lower yen on Japanese exports has helped support output growth in the face of such negative forces as weak confidence, the prospect of significant fiscal retrenchment over the next year or two, and the fact that short-term policy rates can hardly be lowered further. However, it has also brought to a halt the previous decline in the Japanese current account surplus and generated renewed concerns about the possibility of trade tensions with the United States. Elsewhere in Asia, the effective value of many currencies has risen with the dollar and as a result of continuing capital inflows. Competitiveness has thus suffered at the same time as both the volume and prices of exports of electronic goods have been falling sharply. While these developments have helped reduce overheating in many countries in the region, they have also in some cases raised the question of the sustainability of external deficits.

The potential for conflict between internal and external balance is relatively new for many Asian countries, particularly those that have relied on exports as the principal engine of growth. In contrast, this problem has been endemic in Latin America. Policies directed at reducing inflation in the 1990s often relied on the use of the exchange rate as a nominal anchor, usually implying a marked degree of real exchange rate appreciation as domestic inflation responded only with a lag. This had adverse implications for the external balance, exposing countries to a potential loss of confidence both at home and abroad. A similar dilemma is also confronting a number of countries in Eastern Europe. Possible ways to mitigate conflicts of this sort are discussed in the Conclusion of the Report.

Financial developments and measures to strengthen the financial system

There was a sharper focus in 1996 on the implications of the more competitive environment facing financial institutions around the world. Large increases in asset prices and the pervasive search for higher returns in international securities markets drew most attention, raising concerns about exposure to sudden shifts in market sentiment. Moreover, long-standing concerns about the health of banks in some industrial countries were accompanied by a growing awareness of the even greater problems confronting emerging and transition economies.

These recent developments have taken place against the backdrop of rapidly changing technology and continuing deregulation, both of which allowed newcomers (and particularly non-banks) to mount a strong challenge to established financial firms. For similar reasons, the demarcation line between loans and securities became still more blurred, as did the distinction between banks and other kinds of financial institution. The announcement in November 1996 of a prospective Japanese "Big Bang", the further regulatory erosion of Glass-Steagall restrictions in the United States, and the efforts of financial institutions in Europe to position themselves for the introduction of the euro all imply that competitive pressures will intensify further and that financial restructuring is far from over.

In these circumstances, much consideration was given last year to ways of improving the resilience of each of the main structural components of the international financial system – institutional participants, markets, and market infrastructures – with a view to limiting any harmful repercussions from potential shocks. As in previous years, a significant contribution to these efforts was made by committees of national experts meeting at the BIS, each with a focus on one main component of the international financial system. Recommendations made by these committees have a moral (rather than legal) authority arising from the participation of national experts representing domestic constituencies of those most likely to be affected. In this context, a new and welcome development in 1996 was the increasing involvement of representatives of emerging markets in these deliberations and the decisions to which they have led.

Sound financial institutions are at the heart of a sound financial system. To this end, the Basle Committee on Banking Supervision launched a number of new initiatives aimed at refining traditional regulatory instruments last year. In addition, financial institutions were encouraged to disclose more openly their activities with respect to securities trading and derivative instruments. The fundamental premise is that a better-informed market will impose appropriate discipline on its participants. In thus promoting prudent behaviour, it is hoped that the market will increasingly act as a complement to more traditional supervisory practices.

A further major accomplishment in the period under review was the release in April 1997 of a consultative document containing a set of 25 Core Principles for Effective Banking Supervision, supplemented by a three-volume compendium of all the Basle Committee's main publications to date. These principles are a landmark development in at least four respects: they are comprehensive and cover all aspects of supervision; they are addressed to all banks, and not just those that are internationally active; they were drawn up in close consultation with banking supervisors from outside the Group of Ten; and they were designed to provide a checklist of good practice for use by both national supervisors and other interested parties.

It has also been recognised for some time that failures in payment and settlement systems for large-value transactions constitute a potential source of systemic fragility. In 1996 the Committee on Payment and Settlement Systems drew attention to the fact that financial institutions were incurring much more foreign exchange exposure than had previously been supposed and put forward a strategy for dealing with the problem. The Committee also published documents concerning the safety of clearing arrangements for derivative instruments, real-time gross settlement systems and current disclosure practices in securities settlement systems. Finally, in association with other Basle-based committees, the Committee completed a study on the systemic and other implications of the introduction of electronic money and undertook to monitor closely global developments in this area.

The Euro-currency Standing Committee has traditionally focused on the development of new markets and their implications for macro-prudential stability. In addition to introducing a number of refinements to the data it collects on international banking activity, in 1996 the Committee drew up a framework for the regular collection of statistics on over-the-counter derivatives markets. This was accepted by the G-10 Governors in January 1997 for implementation by end-June 1998. Finally, two study groups set up by the Committee began examining the implications for systemic risk of recent structural changes in G-10 financial markets and changes in portfolio management practices. Such topics are obviously very much in the tradition of the earlier work of the Committee and, as in the past, the intention will be not only to identify problems but also to propose potential solutions.